Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FARM CREDIT ADMINISTRATION

12 CFR Parts 615, 618, and 620

RIN 3052–AB48

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; General Provisions; Disclosure to Shareholders; Capital Adequacy

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA), by the FCA Board (Board), proposes amendments to FCA capital regulations for Farm Credit System (Farm Credit or System) institutions to add unallocated surplus and total surplus standards for banks and associations; add a collateral ratio for banks; add procedures for the establishment of individual institution capital standards and for the issuance of capital directives; remove outdated provisions; and make other technical, clarifying, and conforming changes. The regulation would require that each institution maintain at least a minimum level of unallocated surplus and total surplus capital, and that banks maintain at least a minimum collateral ratio. In addition, the regulations would specify procedures for setting higher individual capital standards when warranted by higher risk and issuing capital directives.

DATES: Written comments must be received on or before October 25, 1995.

ADDRESSES: Comments should be submitted in writing to Patricia W. DiMuzio, Associate Director, Regulation Development, Office of Examination, Farm Credit Administration, McLean, Virginia 22102–5090. Copies of all communications received will be available for examination by interested parties in the Office of Examination, Farm Credit Administration.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

I. Summary of Proposed Surplus and Collateral Requirements

System banks and associations should hold sufficient capital to operate in a safe and sound manner, provide a foundation for future viability, and provide a reasonable level of protection to shareholders who must purchase equity in a System institution as a condition of receiving a loan. The FCA proposes to require System banks and associations to maintain the following capital standards in addition to the existing risk-adjusted permanent capital standards:

- A ratio of at least 7 percent of total surplus to risk-weighted assets; and
- A ratio of at least 3.5 percent of unallocated surplus to risk-weighted assets.

For purposes of the total surplus computation, institutions would be permitted to treat the following as surplus: stock held by non-borrowers, allocated stock, and stock held by borrowers that was not purchased as a condition of receiving a loan, provided that all of such stock can only be retired pursuant to a discretionary revolvement plan of at least 5 years or a similar retirement plan. Perpetual stock held by non-borrowers could also be included in the unallocated surplus computations. For the purposes of the total surplus computation, the double counting of association investments in their affiliated banks would be eliminated according to the permanent capital allotment agreements. However, the unallocated surplus measurement for an association would be net of the association's investment in the bank.

In addition, banks would also be required to maintain a collateral ratio of at least 104 percent of eligible assets (as defined by § 615.5050 of existing FCA regulations) to liabilities, net of any bank equities that are being counted as permanent capital of associations.

The existing permanent capital requirements would continue unchanged. An institution that falls below its permanent capital ratio is statutorily prohibited from further retirement of borrower stock, but noncompliance with the proposed surplus and collateral standards would not result in the same prohibition. However, as proposed by these regulations, noncompliance with the surplus or collateral ratios would prohibit the board of directors of an institution from delegating the decision to retire stock to management.

Institutions that do not satisfy the proposed surplus and collateral standards would be required to develop and implement a plan approved by the FCA for building surplus to attain the standards within a reasonable time. An association that does not meet the unallocated surplus standard would have the option, as part of its capital plan, of entering into a risk-sharing agreement with its affiliated bank. Under such a risk-sharing agreement, the bank would share association losses up to an amount not to exceed the amount of bank equities counted as association permanent capital. Institutions meeting the goals of plans approved by the FCA would be considered to be in compliance with their applicable surplus and collateral ratios.

II. Background

Since 1986, the Farm Credit Act of 1971, as amended (Act), 12 U.S.C. 2001 *et seq.*, has required the FCA to ''cause institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such System institutions and by using such other methods as the [FCA] deems appropriate.'' Section 4.3(a) of the Act. Provisions of the Agricultural Credit Act of 1987 (1987 Act), Pub. L. 100–233, added a requirement that the FCA promulgate regulations establishing minimum standards of ''permanent capital'' as defined in the statute. These standards were required to be based on financial statements prepared in accordance with generally accepted accounting principles (GAAP) and to take into consideration relative risk factors as determined by the FCA.

Most of the FCA's existing capital regulations were adopted in 1988, in order to implement the permanent capital provisions of the 1987 Act. Those regulations: (1) Established a minimum permanent capital standard for both banks and associations of 7 percent of risk-weighted assets, after elimination of intra-System reciprocal investments; and (2) prohibited the double counting of capital invested by associations in their affiliated banks. Such capital was to be counted as permanent capital by only one institution, and the regulation specified that eventually only the bank could count it. In October 1992, the statutory definition of "permanent capital" was amended by Congress to permit banks and associations to specify by mutual agreement the amount of allocated equities that would be considered bank or association equity for the purpose of calculating the permanent capital ratio. In July 1994, the FCA amended the regulations to implement the statutory change.

The 1992 statutory change was a response to concerns raised by the System that the 1988 regulatory provisions would have resulted in additional tax liabilities for Farm Credit associations. The associations' investments in their respective banks resulted over a period of many years and largely consisted of allocated equities—that is, earnings that tax-exempt banks distributed to their owner associations in the form of stock or allocated surplus rather than cash. When earnings were distributed in the form of equities, taxes did not have to be paid by the associations.

III. Purposes of Capital

The capital structure of a System institution, at a minimum, needs to fulfill three broad purposes:

A. To provide a cushion that will allow an institution to remain financially viable during periods of adversity, thereby protecting the System institutions, investors, and taxpayers;

B. To provide a source of funds to help stabilize earnings and finance growth; and

C. To denote and protect the ownership, investment, and rights of shareholders.

There are several categories of capital in the System that, in combination, achieve one or more of these fundamental purposes of capital. These categories are: borrower stock; participation certificates; preferred stock; allocated equities; and unallocated surplus. Borrower stock is common shareholder equity purchased as a condition of obtaining a loan with a System institution.[1] Participation certificates are similar to borrower stock and arise from authorized lending relationships with entities and individuals ineligible to own borrower stock.[2] Preferred stock may be sold to individuals separate from the lending relationship and provides preferential treatment, such as the payment of fixed dividends or preference over common shareholders upon liquidation. Allocated equities, including allocated surplus and allocated borrower stock, result from a patronage allocation of an institution's earnings to its active members. Finally, unallocated surplus is the unallocated retained earnings of an institution.

IV. FCA Review and Concerns

The FCA has been engaged in a comprehensive review of its capital regulations to determine whether they create appropriate incentives for the accumulation of adequate amounts of various components of capital, in light of risks undertaken by the System. The FCA has also reviewed the principles of the 1988 international framework for capital standards, known as the Basle Accord, and capital regulations imposed by Federal banking agencies on commercial banks and thrifts, as well as a publication evaluating the adequacy of those regulations by staff of the Federal Deposit Insurance Corporation (FDIC), for information that may be relevant to determining the adequacy of System capital. As a result of this review, the FCA has concluded that the proposed minimum surplus and net collateral ratios would generate an additional level of protection for both borrower/shareholders and investors in the System's debt instruments.

A. Regulatory Requirements Need To Ensure Sufficient Capital

The FCA believes that a mixture of capital components is necessary to achieve a sound capital structure, and that each institution should have a minimum amount of secure capital that is not at risk at another System institution. As a result, the FCA has the following concerns.

1. Long-term Stability for Associations Requires a More Stable Capital Base Than Just Borrower Stock and Should Provide Some Cushion for Borrower Investments

Under existing regulations, it is possible for an institution to rely solely on borrower stock to meet its minimum capital standards, by establishing a stock purchase requirement of 7 percent or more of the loan amount. An institution may then be in compliance but have little or no surplus to cushion the investment of a shareholder. While the shareholder's investment is at risk and provides some protection to the institution, the Agency believes that it is imprudent to make such investments vulnerable to even modest levels of adversity, given the cooperative structure of the System.

For most corporations, common equity capital is generally a permanent source of funds. Once the equity shares are issued, the company permanently retains the proceeds. The stock may trade among investors, but an individual shareholder may not demand that the company retire the stock. Unlike corporate equity capital, System borrower stock may be, and often is, retired upon repayment of a borrower's loan at the board's discretion. If pending losses threaten the value of an association's stock, borrower/shareholders can obtain financing elsewhere, pay down their loan and request retirement of their stock. As a practical matter, in a situation in which the institution still meets its permanent capital requirements, the degree to which borrower stock acts as a buffer for absorbing loss depends on the extent to which the association refrains from retiring stock.

For an association to use this authority in a way that makes borrower stock a meaningful buffer, the association has to recognize potential losses in a timely manner and be willing to withhold proceeds from stock retirement requests. However, such actions can signal problems to existing and potential borrowers at the association. Thus, an association might continue to make retirements until the evidence of serious adverse financial conditions is abundantly clear. By then, the stock of many members may have been retired, and remaining members would bear the loss. Therefore, despite the fact that borrower stock is an at-risk investment like any common equity stock, it is less able to absorb losses than common equity capital. By contrast, a minimum surplus requirement would provide a more permanent source of capital that is capable of absorbing losses and of providing protection to the investments of borrower/shareholders.

Another concern is that an institution can grow in an unbounded manner if each new loan is fully capitalized by borrower stock. Similarly, the institution's capital base can fluctuate significantly when borrowers repay or prepay loans and their stock is retired.

[1] Institutions are authorized to issue common stock to non-borrowers, but no such stock has been issued.

[2] For the remainder of the preamble, further references to borrower stock will include participation certificates, as applicable. Participation certificates are considered to be similar to borrower stock from a financial perspective, even though voting rights differ.

In addition, the most frequent source of an association's financial stress is borrower adversity, whether it is the result of widespread adverse financial conditions (as it was in the mid-1980s), or the result of troubled conditions in a region or industry in which an association has a concentration of loans. As occurred in the mid-1980s, when an institution is unable to retire borrower stock because of financial stress, the institution's business and its borrower/shareholders are adversely affected.

2. ''Local'' Unallocated Retained Earnings (URE) Are Important to Institutions During Periods of Economic Adversity

Over a number of years, most associations in the System accumulated URE, in part, through non-cash earnings distributions from their affiliated banks. Since these non-cash distributions have seldom been retired, some portion of these distributions has resulted in an increase to URE on the associations' balance sheets and yet has continued to be reported as allocated equities on the bank's financial statements. Certain associations have little or no URE that is not also included in the bank's GAAP capital. This group of associations is particularly vulnerable to financial adversity at their affiliated banks because most of their capital other than borrower stock is at risk in both the bank and the association. When a bank sustains losses, all of the bank's capital is available to absorb losses, regardless of whether it is being counted as permanent capital at the association. It follows that such capital will not be available to absorb association losses, which can create a domino effect in troubled times, since adversity in one institution can cause adversity in many or all institutions in the district.

The FCA conducted a study of production credit associations (PCAs) that became financially stressed during the 1980s. The sample used represented a comparable set of financially stressed and healthy institutions. Although the number of institutions and quarters of historical financial data were limited, the FCA was able to make inferences regarding capital levels and long-term viability. The healthy associations, which had unallocated surplus net of their investments in their affiliated banks, were better able to withstand adversity and stay financially viable without assistance. However, associations with no or low surplus, after deducting the investment in the bank, generally could not independently withstand an adverse economic environment without assistance or other action to address their financial deterioration.[3]

A URE cushion that does not include the association's interdependent investment in its affiliated bank provides optimum protection for borrower/shareholders. Losses at the affiliated bank stemming from adversity in other associations or from risks borne by the bank (funding, investment, operational, etc.) could impair the investment in the bank and deplete association capital. Consequently, an association with a large URE and a high permanent capital ratio may not be adequately insulated from adversity if it relies heavily on capital that is invested in its affiliated bank. Strong local URE allows the association to remain viable even if the investment in the bank becomes impaired. The likelihood of the bank and associations sustaining losses simultaneously greatly amplifies the need for a local URE standard.

3. A Sufficient Level of Eligible Collateral Is Needed To Protect Investors in the System's Debt Instruments

The basis for funding banks within the System is the maintenance of sufficient eligible collateral. Performing agricultural loans make up the bulk of eligible collateral,[4] followed by marketable securities and cash. Nonperforming loans and acquired property also provide eligible collateral, after deducting for losses. During the 1980s, the collateral positions of the Farm Credit banks were a critical measure of survival. As an example, the collateral of one bank was exhausted, and the bank lost its ability to independently obtain funding from the marketplace before its capital was depleted.[5]

Farm Credit banks have long used a collateral ratio as a principal indicator of financial strength. Both the Market Access Agreement and the Contractual Interbank Performance Agreement (CIPA)[6] use a collateral ratio as a critical measure of bank financial viability and survivability. A bank failure within the System would have grave consequences not only for that bank and its affiliated associations, but also for the other System banks because of joint and several liability and the market perception of the System as a single entity seeking funding.

The FCA believes that a bank could be shut out of the securities markets if its collateral ratio (as defined in § 615.5050 of the regulations) dropped below 100 percent. Thus, a margin of safety above this level is reasonable, in order to protect investors and allow sufficient time for corrective action to be implemented prior to a funding crisis at an individual bank, and thus district, level. Also, the FCA believes that the net collateral position of a bank, net of its equities counted by associations as part of their permanent capital, affords better protection for both investors and shareholders.

Both the statute and the FCA's capital regulations require a permanent capital calculation that eliminates the double counting of capital shared by System institutions through the allotment agreements. Similarly, the FCA believes a collateral ratio adjusted for the allotment agreements is another appropriate measure of financial safety. This would help ensure that the bank has sufficient capital, net of any capital counted as association permanent capital, to protect investors and shareholders. Specifically, it prevents a bank from placing such equities at risk for investor protection at the same time that associations are placing them at risk for credit and other purposes.

B. Basle Accord and Capital Regulations of Other Regulators

As a part of its review, the FCA has re-examined the 1988 Basle Accord agreed to by the Committee on Banking Regulations and Supervisory Practices, which meets under the auspices of the Bank for International Settlements in Basle, Switzerland. In the existing capital regulations, the FCA incorporated the Basle Accord principles of weighting assets, including off-balance-sheet items, according to categories of risk. However, the FCA did not incorporate in the regulations the two-tiered approach of the Basle Accord, which requires that each institution have at least a minimum amount of ''core capital'' (primarily stable equity capital), which must constitute at least 50 percent of the required capital of the institution. Rather, the FCA treated all types of capital meeting the statutory definition of permanent capital as if they were of

[3] In fact, the stressed PCAs in the study generally had no ''local'' URE. The median value was actually below zero. These PCAs were subsequently merged or provided financial assistance.

[4] Such loans consist of loans made directly by the bank or, in the case of a bank's wholesale lending activities, the loans made by the direct lender associations which are pledged as security for the associations' direct loans from the bank (up to the amount of the direct loan).

[5] The bank was able to maintain access to the funding markets only after certain other System banks agreed to pledge excess collateral to the troubled bank.

[6] These are self-monitoring agreements among the Federal Farm Credit Banks Funding Corporation (Funding Corporation) and System banks that specify levels of bank financial performance, as well as the consequences of a bank's falling below such levels.

equal value to the institution to absorb losses.

The Federal regulatory agencies for commercial banks and thrifts in this country—the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision, and the Board of Governors of the Federal Reserve System—have all adopted capital regulations that are consistent with the Basle Accord framework. In each agency's two-tiered capital system, core or Tier 1 capital is mainly composed of common stock, surplus, noncumulative perpetual preferred stock, and minority interests in consolidated subsidiaries. Supplementary or Tier 2 capital is composed of a portion of the allowance for loan losses and all other kinds of capital and capital-like instruments, up to an amount equal to the amount of Tier 1 capital. The minimum capital requirement is 8 percent. Commercial banks and thrifts also have a minimum leverage requirement, calculated as the ratio of Tier 1 capital to total (*i.e.*, not risk-adjusted) assets, to protect against risks other than credit risk.

Common shareholders' equity in commercial banks and thrifts is the most stable, permanent form of capital because it is fully paid and is rarely retired. By contrast, nearly all of the common equity capital of System associations is borrower stock, which lacks the characteristic of permanence because it is retired in the ordinary course of business of the associations.

The FCA also reviewed an FDIC staff study published in 1993 that compared the risk-based standards for commercial banks to the primary and secondary capital constraints they had replaced.[7] The previous standards differed from the current 8-percent standard in two important ways: the assets were not risk weighted, and all of the allowance for losses (ALL) was included in capital. The study concluded that the risk-based standard was a better predictor of the potential failure of a bank than the previous standards for two reasons: (1) The exclusion of ALL from Tier 1 and its only limited inclusion in Tier 2 improved the quality of the capital measure; and (2) the risk-based measure was more sensitive to credit risk.[8] But the study also concluded that using both the risk-based standard and the new Tier 1 capital-to-total-assets leverage ratio together was a better predictor of failure than either one separately, because in many cases the leverage ratio, which addressed risks other than credit risk, provided a more stringent test of capital adequacy.

C. Farm Credit System Observations

In May 1993, the System's Presidents Planning Committee appointed a capital adequacy work group (System group) with the charge of reviewing the FCA's capital adequacy regulations and making recommendations for improvements. As a result of this effort, in November 1993 the System group provided the FCA with a report of its findings and suggestions. The System group refined this report with a supplemental document submitted to the FCA in April 1994. The System group informed the FCA that the group had consulted with all the banks and a number of associations in developing its final report.

The final report recognized concerns with existing regulatory requirements similar to those identified by the FCA. The System report supported a requirement to build unallocated surplus and allocated surplus to buffer borrower stock from potential losses and to insulate an institution's capital position from the potentially volatile nature of borrower stock. The report noted the important role borrower stock plays in obtaining new loans and retaining quality business, given the cooperative structure of the System. The report also acknowledged the need to protect investors in System securities.

The System group recommended that the FCA establish regulatory standards requiring all institutions to build unallocated surplus and total surplus (*i.e.*, allocated equities and unallocated surplus) by annually retaining a portion of earnings. The System group's proposed goals of 3.5-percent unallocated surplus and 7-percent total surplus were proposed to be achieved by retaining at least 10 percent of net earnings after taxes in unallocated surplus and at least 50 percent of net earnings in unallocated and allocated equities. These objectives were based on the regulatory permanent capital framework and used risk-adjusted assets as the ratios' denominators.

The System group's report also recognized the need to protect investors in System securities. The System recommended that each bank begin reporting to the Funding Corporation its collateral position net of bank equities being counted at associations for permanent capital purposes. The System group stated that its recommendation "effectively prevents the bank from placing such equities at risk for investor protection at the same time that associations are putting them at risk for credit and other purposes pursuant to an allotment agreement," and further that "[i]t gives tangible recognition to the spirit and intent of the . . . 1992 legislation."

Similarities and differences between the FCA's proposed regulation and the System group's suggestions are discussed below in section C of part V.

V. FCA Conclusions and Proposals for Surplus and Collateral Ratios

The FCA makes the following proposals:

A. Surplus and Collateral Requirements

Each Farm Credit institution[9] should have some minimum amount of capital in the form of unallocated surplus, allocated equities or stock not required to be purchased as a condition of obtaining a loan, in order to protect against losses. Part of the surplus should be unallocated surplus that provides a cushion for borrower stock and allocated equities and that does not also support risks in another System institution. The FCA believes that this unallocated surplus would better enable an institution to withstand its own losses and also insulate both the institution and its borrowers from adversities suffered by related System institutions.

1. Unallocated Surplus Requirement

The FCA proposes that institutions have unallocated surplus of at least 3.5 percent of risk-weighted assets. For this purpose, unallocated surplus would include common stock and noncumulative perpetual preferred stock held by non-borrowers, provided that the institution adheres to a policy of not retiring such stock. For associations, the net investment in its affiliated bank—that is, the total investment less reciprocal investments, pass-through stock, and investments related to loan participations—would be subtracted from the unallocated surplus. For both banks and associations, the risk-weighted asset base would be calculated as it is for the institution's permanent capital requirement, except

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[7] John P. O'Keefe, "Risk-Based Capital Standards for Commercial Banks: Improved Capital-Adequacy Standards?" published in the *FDIC Banking Review*, Spring-Summer 1993.

[8] ALL is already excluded from the permanent capital measure for System institutions; so the FDIC staff finding is not directly relevant with respect to the inclusion of ALL. However, the finding is important because it shows the necessity of assuring at least a minimum amount of the highest quality of capital.

[9] "Institution" includes each System bank, System association, and the Farm Credit Leasing Services Corporation. It does not include other System entities, such as other service corporations. The surplus ratios for the Leasing Corporation are calculated the same way as the surplus ratios for banks. However, the Leasing Corporation would not have to maintain a net collateral standard.

that an association's assets would be reduced by the net investment in the bank. The unallocated surplus ratio would be calculated as follows:

$$\frac{(\text{URE}) + (\text{qualifying stock}) - (\text{net investment})}{(\text{Risk-adjusted assets}) - \text{Risk-adjusted net investment})}$$

If this proposed regulation is enacted, the existing requirement in § 615.5330 for banks for cooperatives to add a percentage of earnings to unallocated surplus annually would be replaced by the new requirement.

The FCA believes this minimum unallocated surplus requirement is needed to provide a source of permanent at-risk capital that does not depend on the financial condition of the bank and that protects against the suspension of stock retirements when problems emerge.

2. Total Surplus Requirement

The FCA proposes a requirement that each institution hold total surplus (adjusted according to the permanent capital allotment agreement, or according to the allotment regulation if there is no agreement) equal to 7 percent of risk-weighted assets. The total surplus would consist of the capital treated as unallocated surplus for the purposes of the unallocated surplus ratio (prior to any deductions for investments in the banks), as well as certain allocated equities and other stock. Allocated equities would consist of allocated surplus and allocated stock subject to a discretionary revolvement plan of 5 years or more, or not projected to be retired under the institution's capital adequacy plan. Other stock included in total surplus would be stock other than stock that has been purchased as a requirement of obtaining a loan and would be either perpetual stock or, if term stock, have an original maturity of at least 5 years; furthermore, the institution must adhere to a policy of not retiring the perpetual stock and of not retiring the term stock prior to its maturity. The amount of such term stock that is eligible to be included in total surplus would be reduced by 20 percent in each of the last 5 years of the life of the instrument.[10] The risk-weighted asset base would be the base as calculated for the institution's permanent capital ratio. The total surplus ratio would be calculated as follows:

$$\frac{(\text{URE}) + (\text{qualifying allocated equities}) + (\text{qualifying stock})}{\text{Risk-adjusted assets}}$$

3. Net Collateral Requirement

The FCA proposes that all System banks should also maintain a net collateral ratio of at least 104 percent of eligible assets (which are defined by § 615.5050), exclusive of any amounts counted as association permanent capital, divided by total liabilities. This measure would differ from the measure of eligible collateral that is required by section 4.3(c) of the Act in that it would eliminate any double-leveraged capital by ''netting out'' the capital counted as association permanent capital pursuant to the allotment agreements.[11] A 104-percent minimum net collateral ratio affords an added measure of protection should market forces cause a decline in the underlying value of collateral.

This ratio would also provide the overall protection against other risks that a leverage (*i.e.*, total assets) ratio is intended to address and that ratios based on risk-adjusted assets do not fully provide for. For example, it would provide important information on a bank's ability to withstand losses associated with management and operational risks. Management and operational risks are not readily measurable, but they are often serious sources of risk in a financial institution.

B. Compliance

1. Capital Plans

Institutions that are below any applicable minimum surplus or collateral standards on the effective date of the regulations, or that fall below the minimum standards after the effective date, would be required to develop and submit a capital plan acceptable to the FCA for achieving the minimum standards.[12] The plan would include an explanation of how the institution will build surplus, realistic projections and goals for increasing the pertinent ratios, and a reasonable timeframe for achieving the minimum capital standards. An association that proposes a long timeframe for achieving its minimum unallocated surplus standard would generally be expected to have a Risk-Sharing Agreement, as described below, as part of its capital plan; however, determination of the appropriateness of having a Risk-Sharing Agreement would be made on a case-by-case basis. An institution that is meeting the goals of its approved plan would be deemed by the FCA to be in compliance with the surplus and collateral standards.

2. Risk-Sharing Agreements

a. *Noncompliance on the Effective Date.* Associations that are below their unallocated surplus standard on the effective date of the surplus requirements would have the option of including a Risk-Sharing Agreement with their affiliated bank as a part of their capital plan. Under such a Risk-Sharing Agreement, the affiliated bank could agree to share specified association losses. The maximum amount of such specified losses may not be greater than the amount of the association's investment in the bank counted as association permanent capital during the term of the Risk-Sharing Agreement. While the agreement is in effect, the bank would have to defer sharing in losses when it is below its own minimum capital standards, or when doing so would cause it to fall below them.

An association would be able to count in its unallocated surplus the amount its bank agrees to cover in the event of loss.

[10] Thus, for example, in the first year after its issuance, term stock with a 5-year maturity would count in surplus in an amount equal to 80 percent of its value; in the fifth year, none of the stock would be counted in surplus.

[11] This net collateral position would not replace the collateral requirement of section 4.3(c) of the Act and, indeed, could not do so without a statutory amendment. The FCA is not considering proposing such a statutory change.

[12] Such a plan would supplement or amend the capital adequacy plan required by § 615.5200 of the regulations.

Any association losses actually absorbed by the bank (which would probably be reflected by a reduction of the amount of the association's direct loan) would then have to be allocated back to the association by the bank, which would result in a reduction of the association's investment in the bank.

The FCA notes that an association with a Risk-Sharing Agreement must continue to build unallocated surplus net of the investment in the bank during the time period of its capital plan, so that the association will have achieved at least the minimum standard when the Agreement terminates.

The risk-sharing arrangement would have two potential benefits for the associations. First, an association would be able to report a higher unallocated surplus ratio without directly generating the earnings itself or causing a taxable event. Second, in the event that the association does sustain losses, the sharing of the losses by the bank would mitigate the effect of the losses on the association's loanable funds position. ''Loanable funds position'' refers to the association's levels of interest-earning assets and interest-bearing liabilities. A positive loanable funds position means that interest-earning assets exceed interest-bearing liabilities.

There is also a benefit for the bank and the other associations in the district. That is, the allocation of losses by the bank back to the association would mean that the bank's unallocated surplus would not be reduced by the association's losses shared in by the bank, and the interest rates on direct loans to the other associations should not be affected.[13] Without a loss-allocation requirement, the Risk-Sharing Agreement would require a bank to come to the assistance of an association without ultimately holding the association accountable for that assistance.

b. Subsequent Noncompliance

An association that falls below the unallocated surplus standard subsequent to the effective date of the regulations could propose a Risk-Sharing Agreement with its affiliated bank as part of its capital plan, but the FCA would approve it only under appropriate circumstances. Factors the FCA would consider would include: (1) The causes of the decline in the association's surplus ratio; (2) the present and projected financial health of the affiliated bank and other associations in the district; (3) the bank's continued ability to meet its own capital ratios under risk sharing; and (4) the likelihood that the association will sustain significant losses in the near term.

An example of a circumstance in which risk sharing may be appropriate would be a temporary decrease in an association's unallocated surplus ratio due to a significant and immediate growth in assets. There may also be times when an association is experiencing losses, but the affiliated bank is very well capitalized and the other associations in the district are healthy. In this situation, the prospects are very high that a bank would be able to share an association's losses when needed, without causing undue stress on the bank or other associations in the district. Therefore, a Risk-Sharing Agreement may be appropriate.

3. Other Considerations

In the development of these proposed regulations, the FCA considered making the Risk-Sharing Agreement a permanent means of association compliance with the unallocated surplus standard. If the Agreement were a permanent method of compliance, an association with an Agreement would not be required to build unallocated surplus to at least 3.5 percent net of its investment in the bank. Arguments in favor of doing so are that this approach would better reflect the value to the association of an important intra-System asset and that it would not limit the discretion of an association and its affiliated bank to accumulate earnings at the bank in order to minimize taxes. However, permitting a Risk-Sharing Agreement to, in effect, substitute for unallocated surplus net of the investment in the bank would fail to address an important safety and soundness concern—that is, the concern that institutions have a minimum amount of capital in excess of borrower-owned equities that is not at risk in other Farm Credit institutions. It is only by having unallocated surplus net of its investment in the bank that an association will be insulated from problems that may be suffered by the bank (due, in most cases, to problems at other associations).

As stated above, a Risk-Sharing Agreement would not permit the bank to share association losses if the bank is not meeting all of its capital requirements, including the surplus and collateral requirements.[14] Consequently, in a time of widespread financial stress for Farm Credit institutions, associations with Risk-Sharing Agreements would not be sufficiently insulated from the problems of other Farm Credit institutions, because the bank may be unable to perform under the Risk-Sharing Agreement.[15]

The FCA has, therefore, provided in the proposed regulations that Risk-Sharing Agreements may be used only temporarily as a means of complying with the unallocated surplus requirement and that associations must eventually meet the minimum standard on their own. However, the FCA specifically invites comments and suggestions on the use of the Risk-Sharing Agreements to meet the unallocated surplus requirements on a permanent basis, as well as any alternative methods of ensuring that associations have sufficient surplus that is not at risk in other Farm Credit institutions.

4. Terms and Conditions of the Risk-Sharing Agreement

The term ''Risk-Sharing Agreement'' has been chosen to distinguish the arrangement from the loss-sharing agreements previously entered into by some Farm Credit institutions. Unlike the previous loss-sharing agreements, which obligated one institution to use funds that it had earned to absorb losses at another institution that otherwise had no claim on the funds, the Risk-Sharing Agreement covers only funds earned (albeit allocated from the bank) by an association and accumulated at the bank to absorb losses at that association.

The basic terms and conditions of a Risk-Sharing Agreement would limit the amount of exposure to the bank. Restrictions on such an arrangement, which are intended to protect both parties, would be as follows:

[13] Most wholesale banks in the System currently do not require equalization of associations' investments in the bank; instead the banks compensate their affiliated associations based on the relative size of the association's investment in the bank. The risk-sharing arrangement would work under these circumstances. If the district's associations are required to equalize their relative investments in the bank on a regular basis, risk sharing might not be a viable option.

[14] The FCA recognizes that sharing association losses under the Agreement would not reduce the permanent capital or total surplus ratios of the bank and would only temporarily reduce the unallocated surplus and collateral ratios, until losses are allocated back to the association. However, the risk sharing would result in a reduction of total bank capital, which could eventually expose System investors to greater risk.

[15] The FCA notes that there were complaints from certain System managers during the late 1980s, and even as recently as 1994, about bank assistance to weaker associations. During the 1980s, certain financially strong direct lender associations in some districts expressed reservations about their district bank's provision of assistance to other, weaker associations in the district. The managers of the stronger associations complained that the weaker associations were being given assistance without any requirements to repay, and that the funds were coming from the unallocated surplus of the bank, which, in the view of some, should be used to keep the cost of all direct loans to associations at the lowest level possible.

a. The maximum dollar amount of losses the bank could participate in would be specified by the Agreement and could not be greater than the amount allocated to the association by the bank that is counted as permanent capital of the association. Such amount would be counted in the 3.5-percent unallocated surplus capital of the association.

b. The bank's participation in association losses must begin on or before the point when losses of the association exceed the association's current year's earnings.

c. The percentage of bank participation in a loss could not be less than 25 percent and would automatically increase to 100 percent when the association's unallocated surplus, net of the investment in the bank, is exhausted. In other words, the bank would share losses up to the maximum amount specified in the Agreement before other association capital is charged.

d. The amount committed to risk sharing by a bank could not be reduced, except by payment to the association, until the association's unallocated surplus ratio net of its investment in the bank is in excess of 3.5 percent. The association and the bank may, of course, agree that the bank will share losses of the association even when the association's unallocated surplus ratio exceeds the minimum requirement without counting the amount covered by the Risk-Sharing Agreement.

e. A bank would be prohibited from sharing any association losses under the Agreement when the bank's permanent capital ratio, surplus ratios, or net collateral ratio is below any of the minimum standards, or if sharing in the losses would cause it to fall below any of the standards.

f. A bank would be required to allocate any losses shared pursuant to the Risk-Sharing Agreement back to the association where the loss was incurred. The allocation of losses back to the association, which may be implemented under general cooperative practices in the System, is essential to hold the association fully accountable for losses incurred.[16]

C. Comparison of FCA Proposed Regulations and System Group's Proposal

The FCA's proposed regulations are broadly similar to the System group's suggested approach for establishing unallocated and total surplus standards. However, the FCA's proposed regulations differ with respect to achieving the standards, because the FCA believes that the System's proposal to require that a percentage of earnings be retained annually until the standards are met would not ensure that an institution experiencing growth, making cash distributions, or allocating equities would ever achieve the minimum surplus standards. The FCA proposes instead to require institutions not meeting the standards to submit a capital plan to achieve such standards. The FCA believes that achieving the standards over time is a complex planning issue with many considerations that are best addressed in a comprehensive capital plan. An institution that does not submit, or does not meet the goals of, an acceptable capital plan would not be in compliance with the capital requirements.

The FCA's proposed regulations also differ from the System group's proposal in how the unallocated surplus standard is calculated. The FCA is proposing that URE be reduced by an association's net investment in its bank. This approach would ensure that an association has a level of unallocated surplus to provide for financial strength that is independent of its bank affiliation. The FCA notes that, because the proposed surplus standards are separate requirements apart from the permanent capital standard, the failure to meet the minimum surplus standards would not alone trigger the statutory prohibition on the retirement of borrower stock.

The net collateral ratio for banks is proposed by the FCA to be calculated as recommended by the System group. However, the FCA is proposing that an enforceable minimum regulatory standard be set in lieu of the requirement to report the net collateral position to the Funding Corporation. The FCA concluded that a minimum net collateral standard is key to ensuring the building of capital at the bank to protect investors in System securities and to ensure an early warning mechanism for market access to funding, which is a critical safety and soundness issue.

VI. Retirement of Borrower Stock

As long as an institution's[17] unallocated and total surplus ratios meet or exceed applicable minimum standards, and the permanent capital position is at least 9 percent, the retirement of borrower stock may be delegated by its board of directors to management within certain parameters.

This provision clarifies what kind of delegations may be made by the board to management, consistent with the statutory mandate that stock is retirable only at the board's discretion. If an institution is meeting or exceeding its minimum surplus standards and, if applicable, collateral standard, the board may delegate the decision to retire borrower stock to management provided that the institution's permanent capital will remain at 9 percent or greater after the retirement. Management may make such retirements only in accordance with the institution's retirement policy and must report the aggregate amount of the retirements and their impact on the institution's capital position to the board every quarter. If an institution's surplus and collateral standards are less than the minimum requirements, or if its permanent capital would be less than 9 percent after the retirement, the institution's board of directors must specifically consider and approve each retirement of borrower stock prior to actual cash retirement or payout of the stock.

This proposed regulation is similar to a suggestion made by the System group. The System group recommended that stock retirements be delegable to management when an institution's permanent capital ratio is greater than 8 percent after the retirement, *or* when the institution had reached the surplus requirements (or, if not, had been applying the required proportion of earnings to surplus). The proposed regulation would set a higher permanent capital standard for delegations and would require the institution also to be in compliance with the surplus and collateral standards.

VII. Individual Institution Capital Ratios and Capital Directives

The FCA proposes regulations providing procedures to implement its statutory authorities: (1) To establish individual capital ratios for a single institution, and (2) to issue a capital directive to an institution that is below its minimum capital requirements (including individual institution standards, if any), or to the board of directors of an institution to prohibit the board from reducing the capital of the institution. These authorities would apply with respect to the proposed

[16] The allocation of losses back to the association could be a book entry only, without the actual physical movement of assets. At the association level, capital would decrease because the investment in the bank would decrease. The allocation of losses by the bank would decrease the bank's allocated surplus and restore its unallocated surplus to the level prior to the losses taken under the Risk-Sharing Agreement.

[17] While this provision of the regulation addresses all institutions it is recognized that the delegation restriction would have a limited impact on most banks.

surplus and collateral ratios as well as to the permanent capital ratio. They provide another regulatory tool to the FCA to take appropriate action when an institution's capital is insufficient. The authorities differ from a cease and desist order in that a full hearing (as mandated by section 5.25 of the Act) is not required; therefore, the FCA may respond more quickly in order to minimize further deterioration of an institution's capital position.

These powers were granted to the FCA in 1986, at the same time the Agency was directed to set capital standards for System institutions. The FCA was authorized to ''establish such minimum level of capital for a System institution as the [FCA], in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the System institution.'' Section 4.3(a) of the Act. The FCA was further authorized to issue a capital directive to any System institution failing to maintain capital at or above the required level, including any individual minimum standard. Such a capital directive may, among other things, require the System to submit and adhere to a plan acceptable to the FCA describing how the institution will achieve its minimum capital requirements. Section 4.3(b)(2) and (3) of the Act.

The 1987 Act, which added permanent capital provisions to the Act, prohibited System institutions from reducing the permanent capital of an institution through the payment of patronage refunds or dividends, or the retirement of stock, if the permanent capital of the institution failed, or would fail, to meet the minimum capital adequacy standards established under section 4.3(a) of the Act, including the permanent capital standards. In addition, the FCA was authorized, pursuant to section 4.3A(e), to issue a capital directive to the board of directors of an institution to comply with such prohibitions if the board has failed to do so.

The issuance of a capital directive would be at the discretion of the FCA. Section 5.31 of the Act, as amended by the 1987 Act, provides that a capital directive ''shall be treated as an effective and outstanding order enforceable in the appropriate United States district court in the same manner and to the same extent as a final cease and desist order issued under section 5.25.'' In addition, civil money penalties may be imposed for violation of a capital directive pursuant to section 5.32. A capital directive could be issued in lieu of, in conjunction with, or in addition to other enforcement actions available to the FCA. Furthermore, the FCA could take any available enforcement action in lieu of issuing a capital directive.

These proposed regulations contain procedures for the establishment by the FCA of a permanent capital ratio, surplus ratios and, if applicable, a collateral ratio for an individual institution, as well as for the issuance of capital directives. The regulations are similar to the regulations of the OCC and the FDIC, which have nearly identical authority to the FCA's with respect to individual capital ratios and capital directives. *See* 12 U.S.C. 3907.

For the establishment of individual institution capital ratios, the procedures provide for notice to the institution setting forth the proposed individual capital ratio or ratios, the reasons the FCA has determined that such ratio or ratios are appropriate for the institution, and a statement that the institution has 30 days within which to comment in writing on the proposal. The 30-day time period may be shortened or lengthened in the discretion of the FCA, with proper notice of its action to the institution. The institution has the opportunity to agree to or object to the FCA's proposals and to state the reasons therefor, to propose modifications to the proposal, and to provide documentation or other relevant information, including information about any mitigating circumstances.

For the issuance of capital directives, the procedures are similar—notification to the institution of the proposed capital directive, a 30-day period for the institution to respond, an evaluation of the institution's response, and a determination to issue the capital directive as proposed, to modify it, or not to issue the capital directive at all.

VIII. Other Proposed Changes

A. Exclusion of Impact of FASB 115

The FCA has concluded that unrealized gains and losses should not be reflected in the permanent capital, surplus, or collateral ratios. The FCA is considering the implementation of interest rate risk requirements that would ensure that System institutions have sufficient capital to cover the level of risk taken for interest rates. The current requirements of the Financial Accounting Standards Board's (FASB) Statement No. 115 would include unrealized gains or losses based largely on the shifts in interest rates. Such a requirement may duplicate the efforts of an interest rate risk standard. The FCA notes that the other Federal bank regulators have now eliminated the unrealized gains and losses requirements of FASB Statement No. 115 from their capital standards.

B. Technical and Conforming Changes

The following amendments are being proposed to add new terms to the capital regulations, to remove obsolete terms and provisions, and to make conforming changes in other parts of the regulations:

Section 615.5201 is proposed to be amended to include the terms ''Federal land credit association'' and ''agricultural credit bank'' in the definition of ''institution.'' Changes would also be made to § 615.5220(d) and (e) to include such terms.

Section 615.5216, which granted forbearance to institutions that were below the minimum permanent capital standards when those standards became effective in 1988, is proposed to be deleted from the regulations because all institutions are now in excess of the minimum standard. References to the interim standards would also be deleted in §§ 615.5205, 615.5220(f), 615.5240(a), 615.5250(a)(4)(ii) and (iii), 615.5250(c)(3), and 615.5270(b).

Section 615.5230(b)(1) is proposed to be amended to eliminate the reference to preferred stock issued to the Financial Assistance Corporation. All such stock has been retired.

Section 615.5250(c), which pertains to the mandatory exchange of eligible borrower stock, is proposed to be deleted because all mandatory exchanges have been completed. A related provision in § 615.5260(a) would also be deleted.

Section 615.5260(d), which requires FCA approval of eligible borrower stock retirements other than in the ordinary course of business, is proposed to be deleted. The FCA has determined that it no longer has significant safety and soundness concerns regarding such retirements, because there is only a small amount of eligible borrower stock outstanding, and the FCA has not received an approval request since 1990.

IX. Regulatory Impact and FCA Regulatory Philosophy

These proposed regulations are consistent with the FCA Board's Policy Statement on Regulatory Philosophy and achieve the Board's objective of creating an environment that promotes the confidence of borrower/shareholders, investors and the public in the System's financial strength, and future viability. *See* 60 FR 26034, May 16, 1995.

The objective of the revisions to the capital regulations is to establish standards that encourage the building of a sound capital structure in System institutions. The FCA expects the building of a sound capital structure at each institution to improve the likelihood of an institution's survival during periods of economic stress and thereby improve the safety and soundness of the System as a whole. Additionally, the regulations reflect the importance of capital structure to business viability for System institutions. The FCA believes that regulations implementing these goals must provide a meaningful measurement of capital adequacy and be appropriate for all System institutions.

These proposed regulations will affect all System banks, associations, and the Leasing Corporation because all such institutions will be required to adhere to the standards. However, less than 10 percent of the institutions would be below the standards, if the standards were in effect today, and those institutions will be required to build capital. As of the quarter ending March 31, 1995, 90 percent of the direct lender associations would have met the proposed surplus requirements had the requirements been in place on that date. All of the Federal land bank associations would have met the proposed surplus standards. Of the direct lender associations that would not have been in compliance, two associations would not have met either the total surplus or unallocated surplus ratios, nine additional associations would not have met the unallocated surplus ratio, and four additional associations would not have met the total surplus requirements. However, in most of those associations both types of surplus have been increasing steadily during the past 5 years, and the FCA estimates that most, if not all, of the associations would achieve the minimum standards in 7 years or less if these trends continue.

As of the quarter ending March 31, 1995, all eight banks would have been above the 7-percent total surplus standard.[18] In addition, five of the eight banks would have been above the proposed unallocated surplus ratio and the net collateral ratio. Of those that would not have met the proposed requirements, two banks would have been below the minimum unallocated surplus standard and one bank would have been below the net collateral standard. All banks have been building allocated and unallocated surplus over the past several years, although in some cases the ratios have not increased because assets have also grown.

[18] The FCB of Columbia and the FCB of Baltimore, which merged on April 1, 1995, to form AgFirst, FCB, are treated here as a single bank.

The FCA has determined that the proposed regulations would not have a significant effect upon the general economy. In addition, the proposed regulations pertain only to System institutions and, therefore, would not present a conflict with the rules and regulations of other financial regulatory agencies. Due to the nature of the regulations, it is not anticipated that the regulations will have any material impact upon governmental entitlements, grants, user fees, or loan programs.

List of Subjects

12 CFR Part 615

Accounting, Agriculture, Banks, banking, Government securities, Investments, Rural areas.

12 CFR Part 618

Agriculture, Archives and records, Banks, banking, Insurance, Reporting and recordkeeping requirements, Rural areas, Technical assistance.

12 CFR Part 620

Accounting, Agriculture, Banks, banking, Reporting and recordkeeping requirements, Rural areas.

For reasons stated in the preamble, parts 615, 618, and 620 of chapter VI, title 12 of the Code of Federal Regulations are proposed to be amended to read as follows:

PART 615—FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

1. The authority citation for part 615 is revised to read as follows:

Authority: Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b-6, 2279aa, 2279aa–4, 2279aa–6, 2279aa–7, 2279aa–8, 2279aa–10, 2279aa–12); sec. 301(a) of Pub. L. 100–233, 101 Stat. 1568, 1608.

Subpart H—Capital Adequacy

§ 615.5201 [Amended]

2. Section 615.5201 is amended by adding the words ''Federal land credit association,'' after the words ''Federal land bank association,''; and by removing the words ''National Bank for Cooperatives,'' and adding in their place, the words ''agricultural credit bank,'' in paragraph (g).

3. Section 615.5205 is revised to read as follows:

§ 615.5205 Minimum permanent capital standards.

Each Farm Credit System institution shall at all times maintain permanent capital at a level of at least 7 percent of its risk-adjusted assets.

4. Section 615.5210 is amended by removing paragraphs (f)(2)(i)(D) and (f)(2)(v)(D); redesignating paragraph (f)(2)(v)(E) as new paragraph (f)(2)(v)(D); adding a new paragraph (e)(2)(ii)(G)(*10*); and revising paragraphs (e)(2)(ii)(G)(*7*) and (f)(2)(i)(C) to read as follows:

§ 615.5210 Computation of the permanent capital ratio.

* * * * *

(e) * * *

(2) * * *

(ii) * * *

(G) * * *

(*7*) Each institution shall deduct from its total capital an amount equal to any goodwill.

* * * * *

(*10*) The permanent capital of an institution shall exclude any impact from unrealized holding gains or losses for available-for-sale securities.

(f) * * *

(2) * * *

(i) * * *

(C) Goodwill.

* * * * *

§ 615.5216 [Removed and reserved]

5. Section 615.5216 is removed and reserved.

Subpart I—Issuance of Equities

§ 615.5220 [Amended]

6. Section 615.5220 is amended by removing paragraph (f), redesignating paragraphs (g), (h), and (i) as paragraphs (f), (g), and (h), respectively; removing the words ''may be more than, but'' each place they appear in paragraphs (d) and (e); by adding the words '', agricultural credit banks (with respect to loans other than to cooperatives),'' after the words ''For Farm Credit Banks'' in paragraph (d); by adding the words ''and agricultural credit banks (with respect to loans to cooperatives)'' after the words ''For banks for cooperatives'' in paragraph (e); and by removing the words ''(including interim standards)'' in newly designated paragraph (f).

§ 615.5230 [Amended]

7. Section 615.5230 is amended by removing the words ''preferred stock to be issued to the Farm Credit System Financial Assistance Corporation and'' in paragraph (b)(1).

8. Section 615.5240 is amended by removing paragraph (b); redesignating the introductory paragraph and

paragraph (a) introductory text as paragraphs (a) and (b) introductory text, respectively; adding a new paragraph (c); and revising newly designated paragraph (a) to read as follows:

§ 615.5240 Permanent capital requirements.

(a) The capitalization bylaws shall enable the institution to meet the minimum permanent capital adequacy standards established under subpart H of this part and the total capital requirements established by the board of directors of the institution.

* * * * *

(c) An institution's board of directors may delegate to management the decision whether to retire borrower stock, provided that:

(1) The institution's permanent capital ratio will be in excess of 9 percent after any such retirements;

(2) The institution meets and maintains all applicable minimum surplus and collateral standards;

(3) Any such retirements are in accordance with the institution's capital plan; and

(4) The aggregate amount of stock purchases, retirements, and the net effect of such activities are reported to the board of directors on a quarterly basis.

§ 615.5250 [Amended]

9. Section 615.5250 is amended by removing paragraph (c); redesignating paragraphs (d) and (e) as paragraphs (c) and (d) respectively; by removing the words ''(including interim standards)'' in paragraphs (a)(4)(ii) and newly designated (c)(3); and by removing the words '', including interim standards'' in paragraph (a)(4)(iii).

Subpart J—Retirement of Equities

§ 615.5260 [Amended]

10. Section 615.5260 is amended by removing ''; or'' at the end of paragraph (a)(2)(ii) and inserting a period in its place and by removing paragraphs (a)(2)(iii) and (d).

§ 615.5270 [Amended]

11. Section 615.5270 is amended by removing the words ''(including interim standards)'' in paragraph (b).

12. Subpart K is revised to read as follows:

Subpart K—Surplus and Collateral Requirements

Sec.
615.5301 Definitions.
615.5330 Minimum surplus ratios.
615.5335 Bank net collateral ratio requirements.
615.5336 Compliance.

Subpart K—Surplus and Collateral Requirements

§ 615.5301 Definitions.

For the purposes of this subpart, the following definitions shall apply:

(a) The terms *institution, permanent capital, risk-adjusted asset base,* and *total capital* shall have the meanings set forth in § 615.5201.

(b) *Net collateral ratio* means a bank's collateral position as defined by § 615.5050, less an amount equal to that portion of the allocated investments of affiliated associations that is not counted as permanent capital of the bank, divided by the bank's total liabilities.

(c) *Net investment in the bank* means the total investment by an association in its affiliated bank, less reciprocal investments and investments resulting from a loan originating/service agency relationship, including participations.

(d) *Risk-Sharing Agreement means* a binding contract between a bank and its affiliated association, under which a bank agrees to share losses that the affiliated association may incur and which specifies at least the following:

(1) The maximum dollar amount of association losses to be shared by the bank shall be specified and shall not be greater than the amount of the association's allocated investment in the bank that is counted as association permanent capital.

(2) The participation in losses shall begin on or before the point when losses of the association exceed its current year's earnings, net of non-cash allocated earnings allocated to the association from the affiliated bank.

(3) The percentage of bank participation in a loss shall be not less than 25 percent and shall automatically increase to 100 percent when the association's unallocated surplus less the net investment in the bank is zero.

(4) The dollar amount committed to risk sharing by the bank under the agreement shall not be reduced except by payment to the association, unless the association has an unallocated surplus ratio in excess of 3.5 percent, net of the net investment in the bank.

(5) At any time a bank's permanent capital ratio, surplus ratios, or net collateral ratio is less than the minimum applicable standards or would fall below upon payment, the bank shall defer its payments under the agreement until such time as the payments do not result in the bank's failure to meet its minimum standards.

(6) The bank shall allocate any and all losses shared under the agreement back to the association where the loss was incurred.

(e)(1) *Total surplus* means:

(i) Unallocated retained earnings;

(ii) Allocated equities, including allocated surplus and stock which, if subject to revolvement, have a revolvement of not less than 5 years and are eligible to be included in permanent capital pursuant to § 615.5201(j)(4)(iv); and

(iii) Stock that is not purchased as a condition of obtaining a loan, provided that it is either perpetual stock or term stock with an original maturity of at least 5 years, and provided that the institution has and adheres to a policy of not retiring such perpetual stock and of not retiring such term stock prior to its stated maturity. The amount of term stock that is eligible to be included in total surplus shall be reduced by 20 percent in each of the last 5 years of the life of the instrument.

(2)The surplus of an institution shall exclude any impact from unrealized holding gains or losses for available-for-sale securities.

(f) *Unallocated surplus* means unallocated retained earnings and any common or non-cumulative perpetual preferred stock held by non-borrowers, provided that the institution has and adheres to a policy of not retiring the stock. Any impact from unrealized holding gains or losses for available-for-sale securities shall be excluded from unallocated surplus.

§ 615.5330 Minimum surplus ratios.

(a) *Total surplus.* Each institution shall achieve and maintain a ratio of at least 7 percent of total surplus to risk-adjusted assets.

(b) *Unallocated surplus.* (1) Each institution shall achieve and maintain a ratio of unallocated surplus to risk-adjusted assets of at least 3.5 percent.

(2) Each association shall compute its unallocated surplus ratio by deducting an amount equal to the net investment in its affiliated Farm Credit bank from which it has received allocated equities from both its unallocated surplus and its risk-adjusted asset base, except that the amount specified as the maximum amount of losses to be shared by the bank in a Risk-Sharing Agreement that is in effect shall not be deducted from the unallocated surplus or risk-adjusted asset base.

(c) An institution's total and unallocated surplus ratios shall be computed as of the end of each month.

§ 615.5335 Bank net collateral ratio requirements.

(a) Each bank shall achieve and maintain a net collateral ratio of at least 104 percent of net collateral to total liabilities.

(b) A bank's net collateral ratio shall be computed as of the end of each month.

§ 615.5336 Compliance.

(a) *Association compliance requirements.* (1) Each association that fails to satisfy either or both of its minimum surplus ratios shall submit a plan for achieving and maintaining the standards, with appropriate annual progress toward meeting the goal, to the Farm Credit Administration within 60 days of the month-end in which the failure occurred. If the capital plan is not approved by the Farm Credit Administration, the association shall submit a revised capital plan within the time specified by the Farm Credit Administration.

(2) An association whose unallocated surplus ratio is less than the minimum requirement on [the effective date of the final rule] shall have the option to include a Risk-Sharing Agreement with its affiliated bank in the capital plan, provided that the capital plan also incorporates provisions for achieving and maintaining the unallocated surplus standard exclusive of the Risk-Sharing Agreement.

(3) An association whose unallocated surplus ratio is less than the minimum requirement subsequent to [the effective date of the final rule] may include a Risk-Sharing Agreement in its capital plan only if the Farm Credit Administration approves such inclusion.

(b) *Bank compliance requirements.* A bank that fails to meet its minimum applicable unallocated or total surplus standard or net collateral standard shall submit a plan for achieving and maintaining the standards to the Farm Credit Administration within 60 days of the month-end when the failure occurred for meeting the standard. If such plan is not acceptable to the Farm Credit Administration, the bank shall submit a revised capital plan within the time specified by the Farm Credit Administration.

(c) *Compliance with the use of a capital plan.* An institution that is adhering to a capital plan that has been submitted to the Farm Credit Administration under this subpart and that has been approved by the Agency shall be deemed to be in compliance with the requirements of this subpart.

13. Subparts L and M are added to read as follows:

Subpart L—Establishment of Minimum Capital Ratios for an Individual Institution

Subpart M—Issuance of a Capital Directive

Subpart L—Establishment of Minimum Capital Ratios for an Individual Institution

§ 615.5350 General—Applicability.

(a) The rules and procedures specified in this subpart are applicable to a proceeding to establish required minimum capital ratios that would otherwise be applicable to an institution under §§ 615.5205, 615.5330, and 615.5335. The Farm Credit Administration is authorized to establish such minimum capital requirements for an institution as the Farm Credit Administration, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the institution. Proceedings under this subpart also may be initiated to require an institution having capital ratios greater than those set forth in §§ 615.5205, 615.5330, or 615.5335 to continue to maintain those higher ratios.

(b) The Farm Credit Administration may require higher minimum capital ratios for an individual institution in view of its circumstances. For example, higher capital ratios may be appropriate for:

(1) An institution receiving special supervisory attention;

(2) An institution that has, or is expected to have, losses resulting in capital inadequacy;

(3) An institution with significant exposure due to operational risk; interest rate risk; the risks from concentrations of credit; certain risks arising from other products, services, or related activities; or management's overall inability to monitor and control financial risks presented by concentrations of credit and related services activities;

(4) An institution exposed to a high volume of, or particularly severe, problem loans;

(5) An institution that is growing rapidly; or

(6) An institution that may be adversely affected by the activities or condition of System institutions with which it has significant business relationships or in which it has significant investments.

§ 615.5351 Standards for determination of appropriate individual institution minimum capital ratios.

The appropriate minimum capital ratios for an individual institution cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria. The decision is necessarily based in part on subjective judgment grounded in Agency expertise. The factors to be considered in the determination will vary in each case and may include, for example:

(a) The conditions or circumstances leading to the Farm Credit Administration's determination that higher minimum capital ratios are appropriate or necessary for the institution;

(b) The exigency of those circumstances or potential problems;

(c) The overall condition, management strength, and future prospects of the institution and, if applicable, affiliated institutions;

(d) The institution's capital, risk asset and other ratios compared to the ratios of its peers or industry norms; and

(e) The views of the institution's directors and senior management.

§ 615.5352 Procedures.

(a) *Notice.* When the Farm Credit Administration determines that minimum capital ratios greater than those set forth in §§ 615.5205, 615.5330, or 615.5335 are necessary or appropriate for a particular institution, the Farm Credit Administration will notify the institution in writing of the proposed minimum capital ratios and the date by which they should be reached (if applicable) and will provide an explanation of why the ratios proposed are considered necessary or appropriate for the institution.

(b) *Response.* (1) The institution may respond to any or all of the items in the notice. The response should include any matters which the institution would have the Farm Credit Administration consider in deciding whether individual minimum capital ratios should be established for the institution, what those capital ratios should be, and, if applicable, when they should be achieved. The response must be in writing and delivered to the designated Farm Credit Administration official within 30 days after the date on which the institution received the notice. In its discretion, the Farm Credit Administration may extend the time period for good cause. The Farm Credit Administration may shorten the time period with the consent of the institution or when, in the opinion of the Farm Credit Administration, the condition of the institution so requires, provided that the institution is informed promptly of the new time period.

(2) Failure to respond within 30 days or such other time period as may be specified by the Farm Credit Administration shall constitute a waiver of any objections to the proposed minimum capital ratios or the deadline for their achievement.

(c) *Decision.* After the close of the institution's response period, the Farm Credit Administration will decide, based on a review of the institution's response and other information concerning the institution, whether individual minimum capital ratios should be established for the institution and, if so, the ratios and the date the requirements will become effective. The institution will be notified of the decision in writing. The notice will include an explanation of the decision, except for a decision not to establish individual minimum capital requirements for the institution.

(d) *Submission of plan.* The decision may require the institution to develop and submit to the Farm Credit Administration, within a time period specified, an acceptable plan to reach the minimum capital ratios established for the institution by the date required.

(e) *Reconsideration based on change in circumstances.* If, after the Farm Credit Administration's decision in paragraph (c) of this section, there is a change in the circumstances affecting the institution's capital adequacy or its ability to reach the required minimum capital ratios by the specified date, either the institution or the Farm Credit Administration may propose a change in the minimum capital ratios for the institution, the date when the minimums must be achieved, or the institution's plan (if applicable). The Farm Credit Administration may decline to consider proposals that are not based on a significant change in circumstances or are repetitive or frivolous. Pending a decision on reconsideration, the Farm Credit Administration's original decision and any plan required under that decision shall continue in full force and effect.

§ 615.5353 Relation to other actions.

In lieu of, or in addition to, the procedures in this subpart, the required minimum capital ratios for an institution may be established or revised through a written agreement or cease and desist proceedings under part C of title V of the Act, or as a condition for approval of an application.

§ 615.5354 Enforcement.

An institution that does not have or maintain the minimum capital ratios applicable to it, whether required in subparts H and K of this part, in a decision pursuant to this subpart, in a written agreement or temporary or final order under part C of title V of the Act, or in a condition for approval of an application, or an institution that has failed to submit or comply with an acceptable plan to attain those ratios, will be subject to such administrative action or sanctions as the Farm Credit Administration considers appropriate. These sanctions may include the issuance of a capital directive pursuant to subpart M of this part or other enforcement action, assessment of civil money penalties, and/or the denial or condition of applications.

Subpart M—Issuance of a Capital Directive

§ 615.5355 Purpose and scope.

(a)(1) This subpart is applicable to proceedings by the Farm Credit Administration to issue a capital directive under sections 4.3(b) and 4.3A(e) of the Act. A capital directive is an order issued to an institution that does not have or maintain capital at or greater than the minimum ratios set forth in §§ 615.5205, 615.5330, and 615.5335; or established for the institution under subpart L, by a written agreement under part C of title V of the Act, or as a condition for approval of an application. A capital directive may order the institution to:

(i) Achieve the minimum capital ratios applicable to it by a specified date;

(ii) Adhere to a previously submitted plan to achieve the applicable capital ratios;

(iii) Submit and adhere to a plan acceptable to the Farm Credit Administration describing the means and time schedule by which the institution shall achieve the applicable capital ratios;

(iv) Take other action, such as reduction of assets or the rate of growth of assets, restrictions on the payment of dividends or patronage, or restrictions on the retirement of stock, to achieve the applicable capital ratios; or

(v) A combination of any of these or similar actions.

(2) A capital directive may also be issued to the board of directors of an institution, requiring such board to comply with the requirements of section 4.3A(d) of the Act prohibiting the reduction of permanent capital.

(b) A capital directive issued under this subpart, including a plan submitted under a capital directive, is enforceable in the same manner and to the same extent as an effective and outstanding cease and desist order which has become final as defined in section 5.25 of the Act. Violation of a capital directive may result in assessment of civil money penalties in accordance with section 5.32 of the Act.

§ 615.5356 Notice of intent to issue a capital directive.

The Farm Credit Administration will notify an institution in writing of its intention to issue a capital directive. The notice will state:

(a) The reasons for issuance of the capital directive;

(b) The proposed contents of the capital directive, including the proposed date for achieving the minimum capital requirement; and

(c) Any other relevant information concerning the decision to issue a capital directive.

§ 615.5357 Response to notice.

(a) An institution may respond to the notice by stating why a capital directive should not be issued and/or by proposing alternative contents for the capital directive or seeking other appropriate relief. The response shall include any information, mitigating circumstances, documentation, or other relevant evidence that supports its position. The response may include a plan for achieving the minimum capital ratios applicable to the institution. The response must be in writing and delivered to the Farm Credit Administration within 30 days after the date on which the institution received the notice. In its discretion, the Farm Credit Administration may extend the time period for good cause. The Farm Credit Administration may shorten the 30-day time period:

(1) When, in the opinion of the Farm Credit Administration, the condition of the institution so requires, provided that the institution shall be informed promptly of the new time period;

(2) With the consent of the institution; or

(3) When the institution already has advised the Farm Credit Administration that it cannot or will not achieve its applicable minimum capital ratios.

(b) Failure to respond within 30 days or such other time period as may be specified by the Farm Credit Administration shall constitute a waiver of any objections to the proposed capital directive.

§ 615.5358 Decision.

After the closing date of the institution's response period, or receipt of the institution's response, if earlier, the Farm Credit Administration may seek additional information or clarification of the response. Thereafter, the Farm Credit Administration will determine whether or not to issue a capital directive, and if one is to be issued, whether it should be as originally proposed or in modified form.

§ 615.5359 Issuance of a capital directive.

(a) A capital directive will be served by delivery to the institution. It will include or be accompanied by a statement of reasons for its issuance.

(b) A capital directive is effective immediately upon its receipt by the institution, or upon such later date as may be specified therein, and shall remain effective and enforceable until it is stayed, modified, or terminated by the Farm Credit Administration.

§ 615.5360 Reconsideration based on change in circumstances.

Upon a change in circumstances, an institution may request the Farm Credit Administration to reconsider the terms of its capital directive or may propose changes in the plan to achieve the institution's applicable minimum capital ratios. The Farm Credit Administration also may take such action on its own motion. The Farm Credit Administration may decline to consider requests or proposals that are not based on a significant change in circumstances or are repetitive or frivolous. Pending a decision on reconsideration, the capital directive and plan shall continue in full force and effect.

§ 615.5361 Relation to other administrative actions.

A capital directive may be issued in addition to, or in lieu of, any other action authorized by law, including cease and desist proceedings, civil money penalties, or the conditioning or denial of applications. The Farm Credit Administration also may, in its discretion, take any action authorized by law, in lieu of a capital directive, in response to an institution's failure to achieve or maintain the applicable minimum capital ratios.

PART 618—GENERAL PROVISIONS

14. The authority citation for part 618 continues to read as follows:

Authority: Secs. 1.5, 1.11, 1.12, 2.2, 2.4, 2.5, 2.12, 3.1, 3.7, 4.12, 4.13A, 4.25, 4.29, 5.9, 5.10, 5.17, of the Farm Credit Act (12 U.S.C. 2013, 2019, 2020, 2073, 2075, 2076, 2093, 2122, 2128, 2183, 2200, 2211, 2218, 2243, 2244, 2252).

Subpart J—Internal Controls

§ 618.8440 [Amended]

15. Section 618.8440 is amended by removing the reference ''§ 615.5200(b)'' and adding in its place, the references ''§§ 615.5200(b), 615.5330 (c) or (d), and 615.5335(b)'' in paragraph (b)(6).

PART 620—DISCLOSURE TO SHAREHOLDERS

16. The authority citation for part 620 continues to read as follows:

Authority: Secs. 5.17, 5.19, 8.11 of the Farm Credit Act (12 U.S.C. 2252, 2254, 2279aa–11); sec. 424 of Pub. L. 100–233, 101 Stat. 1568, 1656.

Subpart B—Annual Report to Shareholders

17. Section 620.5 is amended by revising paragraphs (d)(1)(ix) and (g)(4)(ii) to read as follows:

§ 620.5 Contents of the annual report to shareholders.

* * * * *

(d) * * *

(1) * * *

(ix) The statutory and regulatory restriction regarding retirement of stock and distribution of earnings pursuant to § 615.5215, and any requirements to add capital under a plan approved by the Farm Credit Administration pursuant to §§ 615.5330, 615.5335, 615.5351, or 615.5357.

* * * * *

(g) * * *

(4) * * *

(ii) Describe any material trends or changes in the mix and cost of debt and capital resources. The discussion shall consider changes in protected borrower capital, permanent capital, surplus requirements and collateral position, debt, risk-sharing agreements, and any off-balance-sheet financing arrangements.

* * * * *

Dated: July 20, 1995.

Floyd Fithian,

Secretary, Farm Credit Administration Board.

[FR Doc. 95–18323 Filed 7–26–95; 8:45 am]

BILLING CODE 6705–01–P

DEPARTMENT OF THE INTERIOR

Minerals Management Service

30 CFR Part 211

Amendments of Regulations to Establish Liability for Royalty Due on Federal and Indian Leases, and to Establish Responsibility to Pay and Report Royalty and Other Payments

AGENCY: Minerals Management Service, Interior.

ACTION: Proposed rule; notice of extension of public comment period.

SUMMARY: The Minerals Management Service (MMS) hereby gives notice that it is extending the public comment period on a Notice of Proposed Rule, which was published in the **Federal Register** on June 9, 1995. The proposed rule would establish and clarify which persons may be held liable for unpaid or underpaid royalties, compensatory royalties, or other payments on Federal and Indian mineral leases. In response to requests for additional time, MMS will extend the comment period from August 8, 1995, to September 8, 1995.

DATES: Comments must be received by 4 p.m. mountain time on September 8, 1995.

ADDRESSES: Written comments should be sent to the Minerals Management Service, Building 85, Denver Federal Center, P.O. Box 25165, Mail Stop 3101, Denver, Colorado 80225–0165, Attention: David S. Guzy.

FOR FURTHER INFORMATION CONTACT: David S. Guzy, Chief, Rules and Procedures Staff, telephone (303) 231–3432 or (FTS) 231–3432.

Dated: July 21, 1995.

James W. Shaw,

Associate Director for Royalty Management.

[FR Doc. 95–18471 Filed 7–26–95; 8:45 am]

BILLING CODE 4310–MR–P

Office of Surface Mining Reclamation and Enforcement

30 CFR Part 936

[SPATS No. OK–016–FOR]

Oklahoma Regulatory Program

AGENCY: Office of Surface Mining Reclamation and Enforcement (OSM), Interior.

ACTION: Proposed rule; public comment period and opportunity for public hearing.

SUMMARY: OSM is announcing receipt of a proposed amendment to the Oklahoma regulatory program (hereinafter referred